Introduction to Real Estate

Chapter 5: Financial and Real Estate Investing

Standard: **Principles of real estate investing**
(CIP #08.1701-0501)

Objectives:

- Identify trends influencing real estate values.
- Identify different types of investments in real estate.
- Identify other investments that allow an individual to diversify their investment dollar.
- List pros and cons of investing in real estate vs. the stock market.
- Understand the risks involved in any type of investment.

Principles of Real Estate Investing

Information: Purchasing a home can be the largest single investment an individual will make in a lifetime. It can also be a very frightening event, since the decision they make may have a significant impact on their standard of living. It is not a decision to be taken lightly, and the informed investor will benefit from following a few simple guidelines.

Trends Influencing Real Estate Values

Many trends influence the value of real estate. **Fluctuating interest rates due to economic conditions, can make a home affordable one day and out of range another day.** Higher interest rates may cause the value of property to decline in order to make it affordable; lower interest rates have the reverse effect.

There is little an investor can do to impact the interest rates that are controlled by a "superior force," the Federal Government. Keeping an eye on national economic trends is within the investor's power. Learning when to buy or sell can make a big difference in an investor's portfolio.

The local economy of an area will also play an important role in the price of real estate. If an area has suffered some sort of economic blight, such as layoffs, water contamination, crime, etc., the property values will usually decrease. An area in a growth stage will see property values increase proportionately with demand. An average property increase in a healthy economy is 5-10%. If an area is experiencing a rapid growth, that figure may be exaggerated. The investor may want to invest with caution in order to avoid a loss should the growth rate or economic conditions slow down or reverse.

Other factors influencing value, include; the type, size, location, and condition of the property. The timing of the sale will also affect the price. A house may sell for one amount this month, and a very different amount a year from now. Certain locations may become more or less desirable with the passage of time, and this, too, affects the selling price.

There are may types of property matched by the variety of reasons that people invest in real estate. Some people buy real estate because they see it as a safe investment. Although they may not make very much, they will probably not lose very much either. For others, investing in real estate, especially housing, represents security.

Equity

Some people invest in real estate to build up **equity**—the difference between the value of the property and the amount owed on the mortgage. If the property increases in value while they are paying off the mortgage, this increases their equity. Others enjoy the tax advantages of home ownership. People who rent get few tax breaks. Home owners, however, can deduct the interest payments they make on their mortgage loan.

Many believe that there is no safer, surer investment than real estate. In general it *is* a good investment. For instance, in the past 20 years, the median price range has increased from $20,000 to $100,000. You can, however, make a poor real estate investment. You can choose the wrong location. You can choose the wrong time to buy or sell. You can pay too much—either initially or through unexpected hidden costs. You may also choose the wrong type of real estate to invest in. Most real estate investments also include initial costs of purchasing—such as processing fees, title work, and other expenses—of approximately 3%.

Identify Different Types of Investments in Real Estate

Some people invest their money in real estate; others choose different investments. Most people use their real estate investment as a place to live. Others buy various types of property with the intention of collecting rent from others for the use of the property. Whatever investment a person chooses, they usually do so with the intent of making their money work for them.

The past history of real estate investment has generally been favorable. Certain economic conditions, however, have made what should have been a good investment turn sour. Most people have often made money on real estate because the value of property increased over time. The government also gives tax benefits to people who buy their own homes. **Most people find that real estate is their primary investment.**

Because different people have different needs, a variety of homes are available. In addition to the familiar single-and multiple-family houses, there are condominiums, cooperatives, and manufactured homes.

Condominiums

Those who want all the advantages of home ownership but do not want the accompanying maintenance problems, such as snow removal and lawn mowing, may consider an investment in a condominium. A **condominium is an individually owned unit in a building or group of buildings.** The owners of individual condominiums agree to obey a written set of rules that guide the operation of the condominium complex, known as Covenants, Codes, and Restrictions (CC&Rs). The owners pay the mortgages and taxes on their units only. The owners also pay a proportionate share of the expense of keeping up common areas such as hallways, entrances, laundry rooms, and lawns. The condominium owner holds title, the written proof of ownership to his or her unit. The owner, therefore, is free to sell the unit at will to anyone.

There are, however, some disadvantages to condominiums. Many share common walls with neighboring units, so privacy may be sacrificed. Equally important, individual owners have little control over maintenance fees. If most other owners within your condominium building want a particular service, you will have to go along with them and pay for the service.

Timesharing Plans
Some people want to invest in property located in vacation areas, such as mountains or beaches. Since these people will not be using their resort "homes" for more than a few weeks at a time, many choose timesharing plans. In timesharing plans, different investors buy into the same condominium, often for as little as one week at a time. A major disadvantage of time-sharing is that the buyer can select only those weeks that are open. Weeks during prime seasons—winter in a skiing resort, summer in a lake resort—will be in great demand. The cost of these weeks is generally much higher than that of weeks during off-season periods.

Cooperatives
Cooperatives are similar to condominiums, in that they are individual units within larger building. However, you do not actually own a unit. A **cooperative** is a form of ownership in which you buy shares in a nonprofit organization that owns your building. You are, in a sense, responsible for paying a neighbor's share if the neighbor fails to pay. The cooperative, like a corporation, is run by a board of directors. Thus, the board of directors must approve of a buyer before you may sell.

An example of a Cooperative Board denying the sale of a unit to a buyer is when comedian Jerry Seinfeld wanted to buy a unit in a swanky, upper Eastside coop and was turned down. But who wouldn't want Jerry Seinfeld for a neighbor? Apparently the other owners weren't thrilled with the idea of photographers lurking outside their home day and night, crazed fans stalking the doorway, and their security and peace of mind being threatened.

Manufactured Houses
Many people, especially young people just starting out cannot afford traditional houses but want some of the comforts associated with them. For such people, manufactured houses may be a wise choice. Manufactured houses are constructed in factories and then shipped completely assembled to their final sites, usually in a park with similar houses. Most are set on concrete foundations, and are relatively small and easy to maintain. Often they come equipped not only with all the typical household appliances, but also with bedroom, dining room, and living room furniture.

A major advantage of manufactured houses is their low cost of $35,000-$90,000. In many instances, they can easily be paid off within 10 years. Most manufactured homes are put in parks with similar homes. The park charges a rental fee for the pad site and a utility hook-up charge. Other manufactured homes are placed in neighborhoods with homes that have been constructed from the ground-up.

> There is some confusion between a manufactured home and a trailer home. Both are manufactured off-site and brought to the property by truck. The difference is trailers are usually cheaper ($20,000+), and designed to be movable since they have wheels. Some people will remove the wheels, but may return them at a later date if they wish to move the home.

Income Property (Cash Flow Investment)
Many people are not content to sit back and wait until they sell a piece of real estate before they get a return on their investment. These people prefer to invest in **income property**, property on which rent or some other form of payment is earned. Farms, stores, factories, shopping centers, and office buildings are some income properties that you can invest in. Two-to-four-family houses (duplexes and four-plexes) are income property as well. You buy the house, occupy one floor or unit, and rent out the other units. The rental income can then be used to help you pay off the mortgage. Unlike a condominium or a cooperative, a building that you own is yours to run as you wish.

Undeveloped Property (Non-Cash Flow Investment)
Undeveloped property is land that generally is in its natural state. Usually this land is not even cleared. No roads go through it, and utilities such as water and electricity are not yet in. Often, but not always, such land may be fairly inexpensive. People usually invest in undeveloped property with the hope that its value will increase sharply over the years. Sometimes it does. The land may be wanted as the site of a shopping center or housing development. Perhaps a new industrial park may be built on it. In other cases, however, very little may happen to its value. Its value may even go down. A planned highway may never be built, so the undeveloped land along its route may, therefore, remain undeveloped.

Not all the considerations involved in the decision to buy real estate are related to money. For example, some people want to live in a city. Others do not. Some want a home that is small and easy to clean. Others want a large house with plenty of rooms. Some really do not care where the house is located. Others feel that a certain neighborhood or address makes a great difference to their social standing. For some people, a particular house is viewed as a way station as their job takes them from place to place. For others, a house is a permanent residence.

Other Investments that Allow Individuals to Diversify their Portfolio

Collectibles
Some people put their money into **collectibles**: art, antiques, stamps, coins, and other items of value. People who know a lot about the items they collect may get a good return on their investment. However, often years of experience are required to learn which items will increase in value. You have to know a lot about what you are dealing in to be able to distinguish a really good collectible from the ordinary—or from the phony. You know how much of a return you will get on a collectible only when you actually sell it. They are worth only what some other collector will pay for them. If the objects in which you are investing go out of fashion, they may lose almost all their value. An expensive antique item that currently has little demand may not yield as great a return as a comic book that someone needs to complete a collection.

Commodities
Silver teapots and gold charms are collectibles, but silver or gold bars are not. They, along with such other items as wheat, corn, and cotton, are called commodities. **Commodities are agricultural or mining products that can be traded.** People can make a lot of money quickly by trading in commodities. But they can lose all they have gained—and more—just as quickly. Through a market very much like a stock market, a commodities exchange, investors buy contracts for quantities of a given commodity. They buy at a certain price for delivery much later on. However, the investors do not want to take delivery of the commodity. They want to sell their contract sometime before the delivery date. They are hoping that the price of the commodity will rise on the world market. If the price rises, investors can make a healthy profit. If the price goes down, they lose a great deal. Obviously, trading in commodities involves a lot of risk Even when you think you know the market very well, an unexpected event—a freeze that comes just at the time citrus fruit is about to be picked, for example—can spell the difference between rags and riches.

Bonds
Bonds are issued by a business or the government. This is the only resource from which these organizations can borrow money. When you purchase a bond, you loan your money to the issuer of the bond, who pays you interest on the money. Length of investment period, interest rate, and terms vary from one bond to another. Your risk depends on the financial strength of the organization.

Business Investments
Some people use their savings to open a store or start a business. Others invest in a business by buying shares of stock. In both cases, if the business makes a profit, you receive a return on your investment. You may also be able to sell your share of the business for more than you paid for it. Investing in a business is almost always riskier than putting your money into a savings account. However, your return on the investment can be much higher as well.

Stocks
Corporations often try to raise money for expansions and other projects through the sale of stocks. Stocks are shares of ownership of a corporation. A **shareholder** is someone who buys stock and usually has a voice in the operation of the company. Stocks are not a source of funds for the government, since the government is not a business and cannot issue any shares of ownership.

Some investors believe they know enough about stocks to decide on their own which securities to buy or sell. Rather than pay fees for consultation, research, and other services offered by full-service brokers, these investors take advantage of the brokerage services offered by banks and discount brokers. These allow the investor to save on brokerage commissions, but they do not provide advice about which stock to buy.

Mutual Funds
You can also invest in stocks by buying shares in a stock mutual fund. A **mutual fund** is a pool of money used by an investment company to purchase the stocks and bonds, also called securities, of other corporations. When you invest in a stock mutual fund, you entrust your investment dollars to experienced money managers. They research the market before choosing the securities to buy. Since mutual funds can buy from many different companies at the same time, you have less risk of losing part of your investment if one stock performs badly.

Investing in Real Estate vs. the Stock Market

The investor may choose to invest in the stock market vs. the real estate market. For those willing to take a risk, the returns can be exceptionally high; or they may lose some or all of their investment. As with most investments that have the possibilities of high return, the risk factor is proportionately higher.

Before investing in the stock market, one should ask himself several questions:

- Do I want a quick, but risky, return on my investment dollar rather than a slow, but safe, return?
- Can I afford to lose all my investment if the company I invest in fails?
- Do I have enough information to make wise investment decisions?

The answers to these questions will help the investor decide whether to invest in the stock market.

If investing in real estate or the stock market is intimidating, an individual may choose to put their money in a savings account or certificates of deposit, and are satisfied with a lower rate of return for the security they enjoy. Everyone should have some of their resources invested in an account of this sort in order to cover any emergencies that may arise. However, a rate of return of 2-4% per year, against an inflation rate of 5-7%, actually decreases the spendable value of the investment. The investment is still secure, but it is worth less than they were when it was originally placed in savings.

There is no right answer for everyone as to how best to invest their money. Each must determine for themselves what will best fit their personal profile. However, everyone needs shelter, which makes an investment in at least a personal home a wise choice in most situations. Renting is fine for those getting started, but in the long run, they have nothing to show for their dollars spent. The homeowner at least has something to "call their own" and can dispose of it as they see fit.

Risks Involved in Investing

When making an investment decision, the wise investor must determine the return he or she can expect, combined with the risks involved. No investment is totally risk free, although some offer more security than others.

Investing is a personal decision, and is not for everyone. However, those who are willing to take some risks sometimes enjoy substantial rewards. Investors have been known to make substantial gains on an investment, while losing all of an investment on another investment. Before investing, you should ask yourself the following questions:

- Do I want a quick but risky return on my investment dollar rather than a slow but safe return?
- Can I afford to lose all my investment?
- Do I have enough information to make a wise investment decision?
- What are the risks?
- What kind of return can I anticipate?
- How available is the money I have invested?
- How inflation-proof is the investment?
- Does the investment have any tax advantages?
- Will I be comfortable with the investment?

The answers to these questions will help you make decisions that you can be comfortable with. The wise investor will make certain that they have enough money in an insured savings account to meet any emergencies. Then they can feel comfortable putting some money into a high-risk investment.

PRACTICAL APPLICATIONS

1. On a separate piece of paper, list the pros and cons of investing in real estate vs. the stock market. List events—now and in the future—that may have an impact on the choices you make (i.e., war, family size, economic conditions, etc.)

2. When considering the purchase of a home an individual must take into consideration some of the expenses that go along with home ownership. Make a list of at least eight things you can think of and explain how they may make an impact on your investment decision.

Examples: New furnace
Yard maintenance

The most important factor in investing is **TIME.** Why should you invest now? Surely you will be able to afford it more in a few years . . .

	INVESTOR "I will start now"		PROCRASTINATOR "I'll start later"	
Year	Annual Deposit	Deposit + Interest @ 8%	Annual Deposit	Deposit + Interest @ 8%
1	$2,000	$2,160.00	—0—	$0.00
2	$2,000	4,492.80	—0—	$0.00
3	$2,000	7,012.22	—0—	$0.00
4	$2,000	9,733.20	—0—	$0.00
5	$2,000	12,671.86	—0—	$0.00
6	$2,000	15,845.61	—0—	$0.00
7	$2,000	19,273.26	—0—	$0.00
8	$2,000	22,975.12	—0—	$0.00
9	$2,000	26,973.12	—0—	$0.00
10	$2,000	31,290.97	—0—	$0.00
11	—0—	33,794.25	$2,000	$2,160.00
12	—0—	36,497.79	$2,000	4,492.80
13	—0—	39,417.62	$2,000	7,012.22
14	—0—	42,574.03	$2,000	9,733.20
15	—0—	45,976.71	$2,000	12,671.86
16	—0—	49,654.84	$2,000	15,845.61
17	—0—	53,627.23	$2,000	19,273.26
18	—0—	57,917.41	$2,000	22,975.12
19	—0—	62,550.80	$2,000	26,973.12
20	—0—	67,554.87	$2,000	31,290.97
21	—0—	72,956.26	$2,000	35,954.25
22	—0—	78,796.00	$2,000	40,990.59
23	—0—	85,099.68	$2,000	46,429.84
24	—0—	91,907.65	$2,000	52,304.23
25	—0—	99,260.26	$2,000	58,648.57
26	—0—	107,201.09	$2,000	65,500.45
27	—0—	115,777.17	$2,000	72,900.49
28	—0—	125,039.35	$2,000	80,892.53
29	—0—	135,042.49	$2,000	89,523.93
30	—0—	145,845.89	$2,000	98,845.84
31	—0—	157,513.56	$2,000	108,913.51
32	—0—	170,114.65	$2,000	119,786.59
33	—0—	183,723.82	$2,000	131,529.52
34	—0—	198,421.73	$2,000	144,211.88
35	—0—	214,295.47	$2,000	157,908.83
36	—0—	231,439.10	$2,000	172,701.54
37	—0—	249,954.23	$2,000	188,677.66
38	—0—	269,950.57	$2,000	205,931.87
39	—0—	291,546.62	$2,000	224,566.42
40	—0—	314,870.34	$2,000	244,691.74

Getting started is the most important step in investing. Get in the habit of investing NOW, while you are young.

Chapter 5: Financial and Real Estate Investing

Standard: **The impact of real estate investment and income tax**
(CIP #08.1701-0502)

Objectives:

- Understand the approaches to taxation.
- Discuss the tax deductions that are directly associated with ownership of real estate.
- Define capital gain.

Real Estate Investment & Income Tax

Information: As a privilege of living in a country that offers the services that we take for granted, taxes must be collected. In this unit, we will focus on some of the taxes that particularly pertain to property owners and real estate agents.

3 Approaches to Taxation

The tax system applies three different approaches to taxation. These approaches are defined below:

Progressive Tax

A tax that takes a larger percentage of income from high-income groups than from low-income groups. The basic concept is that the wealthy have more resources and, therefore, as personal income increases, the tax rate or bracket goes up. The **national income tax** is considered a progressive tax.

Regressive Tax

A tax that takes a larger percentage of income from low-income groups than from high-income groups. This is based on the concept that if you tax the wealthy less, more people will work harder to be wealthy, and the wealthy will keep more money circulating through the economy. Therefore, as personal income increases, the tax rate goes down, and as personal income goes down, the tax rate increases.

Proportional Tax

A tax that takes the same percentage of income from all income groups. This tax functions on the basis that regardless of income, everyone pays the same tax rate. Examples of proportional taxes are **sales tax and gas tax**.

Tax Deductions Associated with Real Estate Agents and Ownership

Real Estate Agents

Because a real estate agent usually works for a commission only, they are required to keep track of all monies earned, then file and pay their own taxes quarterly. There is no withholding taxes taken out of a paycheck from the broker, so the agent must assume the full responsibility. Deductions become very important.

Some business deductions which are directly associated with a real estate agent include; automobile expenses (i.e. lease or payments, gas, insurance, etc.), pagers, cellular phones, office space (if paying rent), association fees (including MLS usage), training and education, meals, advertising costs, and a variety of miscellaneous expenses. The expenses are high, so a wise real estate agent will keep accurate records so they can itemize these expenses on their taxes.

Real Estate Ownership
Deductions which are directly associated with the ownership of real estate include:

1. Mortgage interest

2. Mortgage discount points (but not the loan origination fee)

3. Mortgage prepayment penalties

4. Property taxes

5. The owner may deduct any of the cost of selling from the selling price. (Cost of selling may include real estate commissions plus other miscellaneous costs.)

6. Depreciation (only in the case of investment property)
Land cannot be depreciated, so cost recovery can only be computed on the value of the improvements. The straight-line method of cost recovery is always used. The allowable number of years for cost recovery is 27.5 years for residential "investment" properties (i.e., rentals), or 39 years for commercial properties. **You cannot depreciate the value of your residence for <u>tax purposes</u>.**

These deductions are available only to property owners, and can be quite substantial when calculating taxes. Most of these deductions are not available to businesses, which expense-out these items (lease payments, etc) as cost of doing business. Businesses do utilize depreciation, however.

<u>Capital Gain and Taxes</u>
The gain realized when selling or exchanging real property is called capital gain and is **taxable.** Property held less than one year (short-term capital gain) is taxable at the same rate as other income. Property held more than one year (long-term capital gain) is taxed at a lower federal tax rate. Some of the rules regarding gain on the sale of real property are as follows *(these laws are continually changing, so check with local real estate Brokers to ensure this information is still correct)*:

1. Capital gain tax rates are 10% of the profits when the seller's normal tax rate is 15%; and either 20% or 25% when the seller's tax rate is 28% or higher. Tax rates are always changing, so sellers should consult with an accountant for current tax rates and information.

2. No taxes are due upon the sale of a personal residence as long as the gain is less than $250,000 for a single taxpayer or $500,000 for married taxpayers filing jointly. Any gain in excess would be taxed at regular capital gain rates.

(To qualify as a "personal residence" the taxpayer must have both owned the residence for two out of the last five years and lived in the residence for two out of the last five years. The years owned and occupied do not necessarily have to be the same time period.) This tax break may be taken every 2 years.

3. Taxpayers can postpone taxes in real estate if they trade one parcel of real estate for another parcel of real estate. The taxes are postponed until the property received is sold at a later date. This is commonly called a "like-kind exchange," or a "1031 exchange." Any cash received in an exchange would be taxable currently.

From an income tax point of view, there are tax advantages to owning investment property. Nearly all individuals are cash basis taxpayers. This means that commissions earned, rents received, and salaries are all taxed when the money is received. Real estate sales are taxed on the date of closing.

Chapter 5: Financial and Real Estate Investing

Standard: **Real estate math.**
(CIP #08.1701-0503)

Objectives:

- Know how to figure simple interest.
- Using the rule of 10's, determine the approximate principal and interest payment on a loan.
- Know how to calculate commission and splits with other agents.
- Know how to calculate capitalization rate.

Performance Objective:

- **#4. Calculate simple interest.**
- **#5. Calculate commission and splits with other agents and brokers.**

Real Estate Math

Information: Arithmetic is commonly used in the real estate industry. This can create a great deal of apprehension for some people. However, most real estate mathematical problems only requires a grade-school level of arithmetic ability. Using the diagrams and examples in these lessons, a student may answer any of the questions on the real estate state examination.

Before we get started, a quick review of percentages, decimals, and fractions is recommended. Real estate requires a person to make these common conversions.

Percentages	Fractions	Decimals
5%	1/20	.05
6-2/3%	1/15	.067
10%	1/10	.1
12-1/2%	1/8	.125
16-2/3%	1/6	.167
25%	1/4	.25
33-1/3%	1/3	.33
50%	1/2	.5
66-2/3%	2/3	.67
75%	3/4	.75
100%	1	1.00

Let's practice changing a percent to a decimal. Simply remove the "%" and place a decimal two places to the left. **Example:** 6% = .06 or 4-1/2% = .045

Then turn a simple fraction into a decimal. Divide the top number (numerator) by the bottom number (denominator). **Example:** 4/5 = 4 ÷5 = .80

Percent	Decimal
75%	
20%	
80%	
12.5%	
30%	
67-1/2%	
56-1/4%	

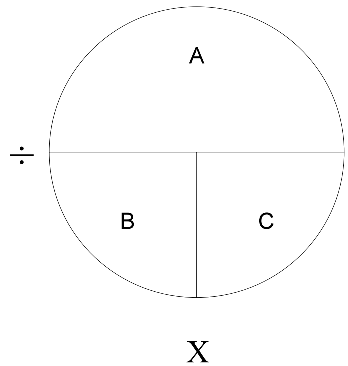
Fraction	Decimal
3/4	
14/25	
1/8	
1/5	
3/10	
67/100	
3/4	

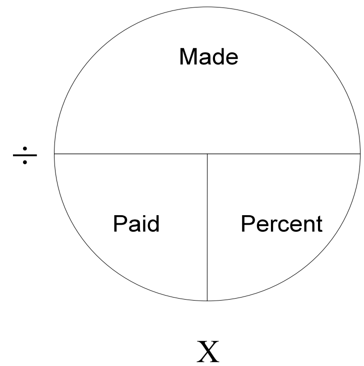
Basic Math Problems
Most of the questions on the state examination can be answered by applying the following basic math formula. In the following diagram, it is important to remember the horizontal line is a dividing line; the vertical line is a multiplying line. In most math problems in the state examination, the student will be given two factors and will be asked to find a third. This diagram helps to isolate those factors and indicates to the student what to do with the two numbers given in the following terms:

$2 \times 3 = 6$

$6 \div 2 = 3$

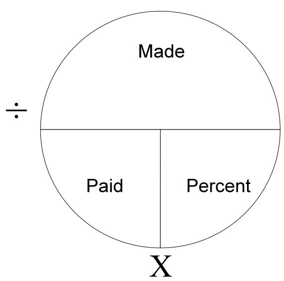
$6 \div 3 = 2$





Paid x Percent = $ Made

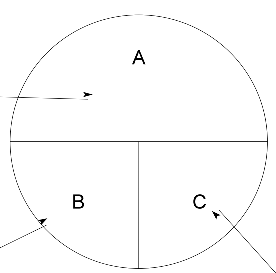
Example: If a man paid $50,000 for a business which gave him a 6% return on his money, how much did he make during the first year he owned it? *Place the numbers within the circle formula and show all calculations.*



Circle Formulas

Rules to Remember

1. Income (net)
2. Yield
3. Profit/Loss
4. Commission
5. Interest
6. Taxes
7. Area



1. Investment
2. Value
3. Cost
4. Sales Price
5. Loan Balance
6. Assessed Value
7. Length
8. Principal

1. Rate of Return
2. Capitalization Rate
3. Commission Rate
4. Interest Rate
5. Tax Rate
6. Profit/Loss Rate
7. Width

Figuring Simple Interest and Other Math Problems

Using the circle formula, let's try some basic real estate math problems. Pay attention to the rules!

The formula for interest is: Principal x Rate x Time = Interest
Remember all circle formulas use annual numbers (Time = 1 year). Compensate for this when needed.

REQUIRED PERFORMANCE COMPETENCY

#4. Calculate simple interest. *If you do not get the correct answers for all 4 problems, have your teacher supply you with other simple interest problems in order to pass this state competency requirement.*

1. You get a one-year loan for $5000 at an annual rate of interest of 6%. How much will you pay in interest for the year? If you make 12 equal payments, what will you be paying each month to pay-off the loan? *Show calculations.*

2. You procure a $15,000 loan to buy a trailer home. The loan is for 5 years at an annual interest rate of 7-1/2%. How much interest will you pay over the 5 years? *Show calculations.*

3. If you get a $236,000 loan for your home at an annual rate of interest of 5-3/8%, how much interest will be paid over the 1st year? *Show calculations.*

4. The annual rate of interest on a mortgage loan is 8-1/2%. The monthly interest payment is $201.46. What is the principal amount of the loan? *Show calculations.*

Calculate the Capitalization Rate (Cap Rate)

Estimating the rate of return an investor demands from his investment properties. Determined by comparing the relationship of ANNUAL net operating income (NOI) to the sales prices of similar properties that have sold in the market.

Income ÷ Rate = Value	Potential Gross Income
Income ÷ Value = Rate	− Vacancies and Expenses
Rate x Value = Income	= Annual Net Operating Income (NOI)

NOI ÷ Cap Rate = Value of Property

1. If a property's annual net income is $24,000 and it's valued at $300,000, what is the capitalization rate? *Show calculations.*

2. The effective gross annual income from a property is $112,000. Total expenses for this year are $53,700. What capitalization rate was used to obtain a valuation of $542,325? *Show calculations.*

3. What would a business be worth if it showed a profit of $585 monthly and earned 13% per year on the total investment? *Show calculations.*

4. An apartment complex has a potential gross rental income of $500,000 with 80% occupancy. Annual expenses are $150,000. Similar properties have a Cap Rate of 8%. Using the income approach, what is the value of the apartment complex? *Show calculations.*

Estimating Monthly Principal and Interest Payments

Following is an easy way to quickly "estimate" what you monthly mortgage payment will be (principal and interest only) on a 30-year fixed note. For our purposes only, we'll refer to it as:

The Rule of Ten's.

For every $10,000 borrowed, multiply that number by the interest rate times 10.

Example: $180,000 borrowed at 7.5% interest

$180,000 ÷ $10,000 = 18

7.5 x 10 = 75

18 x 75 = $1,350 (Principal and Interest payment)

Actually = $1,259 (Less than $100 difference and so much simpler than using an amortization calculation)

1. On a 30-year Fixed loan, you borrow $290,000 at 6% interest. What is your estimated monthly P& I payment? *Show calculations.*

2. On a 30-year Fixed loan, you borrow $167,000 at 8-3/4% interest. What is your estimated monthly P& I payment? *Show calculations.*

3. On a 30-year Fixed loan, you borrow $392,500 at 7-7/8% interest. What is your estimated monthly P& I payment? *Show calculations.*

Calculating Commission and Splits with Other Agents and Brokers

Most all real estate agents and brokers work for commission, meaning they receive a percentage of the sales price as their service fee. A typical commission on the sale of residential property is 5-7%. The typical commission for commercial property and raw land is 10%. This money is paid by the seller in most all cases.

The following is a typical breakdown of a commission received on an average home.

Sales Price:	$250,000		
Commission Rate (6%): X .06			
Agent Receives:	$15,000	**Seller Keeps:**	$235,000

However, in most cases the buyer and seller are represented by two different agents. When this is the case, the selling agent "splits" his commission 50/50 with the buyer's agent. So in the example above, each agent would receive 3% which is $7,500. As you see, the number of agents involved does not affect the sales price, nor the amount of money the homeowner (seller) keeps.

Remember, most real estate agents work for a company like Century 21 or ERA, whereby the office is owned and operated by a broker. In this case, the broker is going to want a cut of the agent's commission to pay office expenses and his own salary. *(He's not going to let you work for free!)* Depending on the agreement the agent negotiated with his broker, his commission split with the broker can be anywhere from 50-80% *(20% to the broker; 80% to the agent)*. The more experienced and well-marketed agents can negotiate a better rate because their volume of sales is typically higher than someone who just received their license. The benefit of working in this environment, is if you don't make a sale one month, you don't have to pay the broker any money.

Not to confuse you, but in some companies like Re/Max, agents don't split commissions with their broker, but instead pay a flat, monthly fee for use of the office, equipment, secretary, etc. Agents who work for Re/Max must pay each month no matter if they make a sale or not. Typically, the best agents work for companies like Re/Max because they can make 100% of their commission which more than makes up for the amount they pay for office space.

Sales Price:	$250,000		
Commission Rate (6%): X .06			
	$15,000		
Agent Split (50%):	X .50		
Buyer's Agent:	**$7,500**	**Seller's Agent:**	**$7,500**
Buyer's Agent (50/50 split)		Seller's Agent (80/20 split)	
	$7,500		$7,500
	X .50		X .80
Buyer's Agent Receives:	**$3,750**	**Seller's Agent Receives:**	**$6,000**

As you can see, the actual commission received by an agent is quite a bit less than the original $15,000. Whatever the actual commission received, an agent must consider the following additional expenses (using $3,750 agent commission):

Buyer's Agent Commission:	**$3,750**
Agent Overhead—25%	– $938
Marketing Call Phone & Long Distance Auto (Purchase, Gas, Insurance, Maintenance) Training Business Cards Name Rider Signs/Badges	
Taxes—30%	– $ 1,125
Retirement–10%	– $375
Profit	**$1,312**

Other expenses must be taken into consideration when calculating the expense of being a real estate agent. These expenses include:

Association Dues (state, monthly, annual)
Food (Lunches and dinners for self and clients)
Continuing Education and Training
Clothing
Child Care

Selling an average of 1 property per month (12 properties per year) would net an agent less $15,744 when you combine ALL expenses; far below the national poverty rate.

Anyone considering a career in real estate must understand that it is going to take a lot of hard work to justify the expense of being in the business. A successful agent can easily earn in the six-digit figures; an average agent will net approximately $20,000–$30,000 per year. The majority of agents, however, earn less than $10,000 per year. It is a matter of commitment and time, and working smart.

REQUIRED PERFORMANCE COMPETENCY

5. Calculate commission and splits with other agents and brokers

If you do not get the correct answers for both problems, have your teacher supply you with other commission problems in order to pass this state competency requirement.

1. You work for Movin' Up Realty. You have negotiated a split with your broker to make 60% of the commissions you bring in. You have listed the home of Mr. Johnson for $315,00 at a commission of 5%, and have been working hard to find a buyer. Your listing contract is good through June 30th.

   Martha Smith from Mega Realty has brought her buyers from out of town to look at the Smith's home. *(Ms. Smith generally receives a 7% commission on the homes she lists.)* Her clients love the house, and send over a contract offering $295,000. Your client, Mr. Johnson counters at $307,000 and the counteroffer is accepted.

   How much will your broker cut you a commission check for? *Show calculations.*

2. On the average, **how many homes per month** would you have to sell to net $40,000 per year **after** taxes and expenses? (Assume for every transaction, you only represent one entity in the sale (50/50 split). *Show calculations.*

Average home price:	$167,000	Taxes:	30%
Average Commission:	6%	Misc/Ad Expenses:	25%
Agent/Office split:	60/40		